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IN THE

Supreme Court of the United States

OCTOBER TERM—1941

No. ~~1233~~ 89

PALOMA ESTATES, INC.,

Petitioner,

vs.

SERIES C-2 TRUSTEES

and

SECURITIES AND EXCHANGE COMMISSION.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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Paloma Estates, Inc.

THE COURT PRESS, N. Y. C.

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To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Paloma Estates, Inc., the debtor herein, a corporation organized under the laws of the State of New York, prays this Court for the issuance of a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit to review a decree of that Court entered February 21st, 1942, affirming an order of the United States District Court for the Southern District of New York dismissing a petition of the debtor for reorganization under Chapter X of the Bankruptcy Act.

Opinions Below.

The majority and dissenting opinions of the Circuit Court of Appeals (R. 97-102) are reported in 126 Fed. (2d) 72. The opinion of the District Court (R. 79-83) is reported in .....

Jurisdiction.

The decree of the Circuit Court of Appeals was entered on February 21, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Questions Presented.

Section 141 of the Bankruptcy Act provides that a petition filed under Chapter X shall be dismissed if not filed in good faith. Section 146 (4) provides that a petition shall be deemed not to be filed in good faith if "a prior proceeding is pending in any Court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding". The question presented is whether under these provisions a bankruptcy court must relinquish the jurisdiction conferred upon it by Chapter X in favor of a pending state court reorganization proceeding, upon a mere showing that the debtor company, which filed the petition under Chapter X once consented to a plan in the state court proceedings for an extension of a mortgage on its property, and without any showing that the interests of the debtor's creditors and stockholders would be better safeguarded in the state court proceedings than in the proceedings under Chapter X.

Statutes Involved.

Section 141 of the Bankruptcy Act (11 U. S. C., Sec. 541) provides as follows:

> "Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied."

Section 146 of the Bankruptcy Act (11 U. S. C., Sec. 546) provides in part as follows:

> "Without limiting the generality of the meaning of the term 'good faith', a petition shall be deemed not to be filed in good faith if—* * * (4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding."

Statement.

The Debtor is the owner of land and a nineteen-story apartment building erected thereon, located at 200 West 86th Street, New York City. The building was constructed by the Debtor in 1931. It consists of 228 apartments, comprising 860 rooms and 15 stores. The property is subject to a first mortgage originally held by the New York Title & Mortgage Company as part of a certificated issue of $24,000,000, known as Series C-2, and which is represented by certificates distributed and held by numerous certificate holders. In addition thereto, the property is subject to a second mortgage on which there is a balance due of $60,000; the Debtor also owes $3,000 in unsecured indebtedness (R. 7-8, 80-81, 98).

As a result of the liquidation of the New York Title & Mortgage Company, the Supreme Court of the State of New York, pursuant to the provisions of Chapter 745 of the Laws of 1933 of the State of New York as amended (commonly referred to as the Schackno Act) appointed trustees of the C-2 mortgage investments issued and guaranteed by the New York Title & Mortgage Company, which trustees became the owners of the first mortgage covering premises 200 West 86th Street, New York City, for the benefit of certificate holders. In 1936 the property was in arrears to the extent of $100,000 and by the terms of an extension agreement then effected, the Debtor (R. 81, 98) agreed to discharge said arrears by the payment of $50,000 in cash and payment of the balance in five yearly installments of $10,000 each. The mortgage was extended for a period of five years and provided for the payment of interest at the rate of 4½% for the first and second years; 4¾% for the third and fourth years, and 5% for the fifth year of the extension agreement. The Debtor was unable to meet the November 1, 1940 interest and taxes and at the request of the Series C-2 Trustees, executed and delivered to the Trustees an assignment of rents. The Series C-2 Trustees, in turn, designated Emanuel M. Krulewitch, president of the Debtor corporation, as its managing agent and he continued to operate and manage the property for the said Trustees until June 16, 1941 (R. 81, 98, 99).

During the interim and before any default, the Debtor had some negotiations with the Trustees with respect to a modification of the extension agreement, which finally took the form of an offer to buy the mortgage partly in cash and the remainder in Series C-2 certificates. The Debtor was unable to carry out this plan and negotiated with the Trustees for a modification of this plan, which was formally outlined and submitted for approval to

Judge Noonan by the Debtor and the Trustees, but before approval was granted, Judge Noonan died. Thereafter, the Debtor, through its attorney, requested the Trustees to submit the plan to the Judge who succeeded Judge Noonan at the Additional Special Term. Despite the lapse of a period of eight months, the Trustees failed and refused to act thereon (R. 99, 69-74).

Thereafter, the Debtor filed its petition under Chapter X of the Bankruptcy Act on June 18, 1941 (R. 2-6). By order of the District Court Judge, the Securities and Exchange Commission was made a party to the proceedings and at the hearing, filed a brief in support of the jurisdiction of the Bankruptcy Court (R. 79-80). The Trustees filed an answer to the petition of the Debtor and moved to dismiss the petition as not filed in good faith (R. 9-19). No trial was had on the issues before the District Court, dismissal of the petition having been made by the District Judge solely upon the formal pleadings and arguments and briefs of counsel for the Debtor, the Trustees and the Securities and Exchange Commission. The District Court Judge, reciting in his opinion that the Trustees' defences, as formally pleaded, were "sufficient in law and sustained by the proof" relied on *Brooklyn Trust Company* v. *Rembaugh,* 110 Fed. (2nd) 838, 42 American Bankruptcy Reports (N. S.) 233 and *In re Blinrig Realty Corp.,* 114 Fed. (2nd) 100, 43 American Bankruptcy Reports (N. S.) 416 (R. 82).

An appeal from the order dismissing the petition was taken by the debtor to the United States Circuit Court for the Second Circuit and the Circuit Court, in a divided opinion, affirmed the order of the District Court (R. 97-102).

Specification of Errors to be Urged.

The majority of the Court below erred:

1. In holding that the debtor's petition for reorganization under Chapter X of the Bankruptcy Act was not filed in good faith.

2. In holding that there was an absence of good faith on the part of the debtor because the debtor had assented to a modification and extension of and a plan of liquidation covering the satisfaction or assignment of a certificated mortgage in a state court proceeding.

3. In failing to determine whether or not the interests of creditors and stockholders would be better subserved in the state court proceedings than in proceedings under Chapter X of the Bankruptcy Act, and whether or not such state court proceedings would provide for public investors safeguards equivalent to those provided by Congress in Chapter X.

4. In holding that the state court proceedings under the Schackno and Mortgage Commission Acts were "prior pending proceedings" within the meaning of Section 146 (4) of Chapter X.

5. In failing to have a hearing on the facts prior to determining the issues presented.

6. In failing to reverse, and in affirming, the order of the District Court.

Argument.

1. This Court recently, on March 16th, 1942, granted a writ of certiorari on an application which involved points identical with those presented in this petition. *Marine Harbor Properties Inc.*, petitioner, vs. *Manufacturers Trust Company*, as Trustee, etc., et al., #948; 62 Supreme Court, 907. The Securities and Exchange Commission which had there been a party in the District Court and Circuit Court proceedings, in which it consistently supported the position taken by the petitioner, joined with the latter in the petition for certiorari and filed a supporting memorandum. The Circuit Court of Appeals for the Second Circuit, in both the *Marine Harbor* and in the instant proceeding relied upon several earlier cases which dealt with the effect of prior state court proceedings on the issue of a debtor's good faith in the filing of a petition under Chapter X of the Bankruptcy Act. See *Brooklyn Trust Co.* v. *Rembaugh*, 110 F. (2'd) 838; *In re Blinrig Realty Corp.*, 114 F. (2'd) 100.

Both the *Marine Harber* and the present case involve construction of the good faith requirements under Sections 141 and 146 (4) of the Bankruptcy Act, which made good faith a condition precedent to the assumption by the District Court of jurisdiction over a debtor's petition under Chapter X. In Section 141 Congress provided that the District Courts are not to assume jurisdiction over a debtor's petition under Chapter X if it is not filed in good faith and in Section 146 (4) that a petition shall be deemed not to be filed in good faith where a prior proceeding is pending in another court. "And it appears that the interest of the creditors and stockholders would be best subserved in such prior proceedings."

The Circuit Court of Appeals for the Second Circuit, with Judge Frank dissenting in the *Marine Harbor* case

and Judge Clark dissenting in the instant case, refused to entertain the debtor's petition, having resolved the question of good faith in terms of an assumed personal disqualification on the part of the debtor, arising merely out of the latter's participation in prior state court proceedings. The Court relied on the *Rembaugh* and *Blinrig* cases in construing the foregoing provisions of the Act to require that the District Court dismiss all petitions filed by a debtor company whenever it is shown that the debtor actively participated in prior state court proceedings irrespective of whether the prior proceedings provided safeguards for public investors comparable to those found in Chapter X. In adopting that view, the Circuit Court acted in apparent disregard of the clear terms and obvious purport of the Statute.

Judge Clark, dissenting from the opinion below, cited with approval Judge Frank's dissent in the *Marine Harbor* case and the Law Review criticisms, Siegel, Chapter X or Schackno Act Proceedings, 27 Corn. L. Q. 56-73; 18 N. Y. U. L. Q. Rev. 399, 418, and proceeded to state:

> "I cannot avoid the conviction that we are substituting an inadequate state proceeding for the carefully safeguarded proceedings in reorganization devised by Congress for cases such as this, where the public interest may be protected by the public agency of the Securities and Exchange Commission. And this, it seems to me, is as practically undesirable as it is legally unjustified" (R. 101).

Moreover, he, pointed out the impropriety of disposing of the good faith inquiry without a hearing and on the sole basis of formal pleadings supported by affidavit proof. He rejected the approach of the majority which unduly emphasized the activity of the debtor in disre-

gard of the statutory requirement that the District Court take jurisdiction unless it found, after conducting an investigation, that "the interests of creditors and stockholders would be best subserved" in the prior state court proceedings (R. 102).

The Securities and Exchange Commission, in its memorandum supporting the petition for certiorari in the *Marine Harbor* case, referred to the instant case, adopted the reasoning of Judge Clark's dissent in the Circuit Court and criticized the disregard by the majority of the Court of the interests of the debtor's creditors and stockholders in contravention of the purpose of the statute. That memorandum forcefully said in part:

"Moreover, the assumption that the personal bad faith of the debtor, if deemed to exist, is relevant to the propriety of the exercise of jurisdiction by the bankruptcy court ignores the essential elements of the statutory scheme devised by Congress. Congress provided the safeguards of Chapter X for the benefit of investors; it directed that consideration be given to the interests of creditors and stockholders. To ignore the real parties in interest and to attach weight to the conduct of the fictional legal entity known as the debtor is to nullify the purposes of the Act. The motives of the debtor itself are unimportant, because once the petition is filed the court, not the debtor, has control of the proceedings. See *Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, 125-126. Under the rule enunciated in that case the debtor and its stockholders can gain no strategic advantage from the pendency of the proceedings and their interests will be entirely eliminated unless a surplus remains after payment of all creditors in full (id., 131). Indeed, the more questionable may be the motives of the debtor or the persons controlling it, the more

reason there is for the court to take jurisdiction and to make available to creditors and stockholders the safeguards of Chapter X.

"4. Had the court below directed its attention, not to the alleged 'personal disqualification' of the debtor, but to the effect of the dismissal of the petition upon the interests of the creditors and stockholders, its decision would necessarily have been different."

The decision below patently calls for review by this Court.

2. The state court proceedings do not meet the requirements of Section 146 (4) to justify the dismissal of the debtor's petition. The prior proceeding had been conducted under the so-called Schackno Mortgage Commission Acts of New York.[1] As the Securities and Exchange Commission pointed out in the memorandum referred to, the state procedures "* * * lack almost all the basic safeguards for the protection of security-holders provided by Congress in Chapter X. There is no searching investigation of the debtor's past management and of its present business and prospects which is required through the medium of an independent trustee under Section 167 of the Bankruptcy Act. There is no provision similar to that requiring participation in Chapter X reorganization proceeding by the Securities and Exchange Commission. There is no requirement that a plan must receive preliminary approval by the court before the assent of security-holders may be obtained (cs. Section 176 of the Bankruptcy Act) or that information must be furnished to security-holders (cf. Section 175 of the Bankruptcy Act); and there are no protective provisions as

[1] L. 1933-c.745 as amended; N. Y. Unconsolidated Laws, Sections 1796 *et seq.;* L. 1935-c.19 as amended; N. Y. Unconsolidated Laws, Sections 1751 *et seq.*

to the form of reorganization (cf. Section 216 of the Bankruptcy Act). Indeed, Chapter X has the same superiorities over the state court procedure as this Court held that it has over the procedure provided in Chapter XI of the Bankruptcy Act. See *Securities and Exchange Commission* v. *U. S. Realty & Improvement Co.*"

The Commission noted with emphasis, citing *Securities and Exchange Commission* v. *U. S. Realty & Improvement Co.*, 310 U. S. 434, that Chapter X provides an integrated and carefully fashioned procedure for the reorganization of corporations and for the protection of their security holders, in the following essential aspects:

> (a) There is control by the Court over security holders' committees and the formulation of reorganization plans (310 U. S. 449).
>
> (b) There is impartial and expert administrative assistance through participation in the proceedings by the Securities and Exchange Commission (*ibid.*).
>
> (c) There is provision for the appointment of a disinterested trustee and for an investigation and report by such trustee concerning the debtor's financial problems and management.
>
> (d) There is assurance that security holders will not be required to vote on any proposed plan of reorganization until they have received full information concerning the plan and until the plan has been initially approved by the Court.

That procedure under Chapter X is to supersede all conflicting state procedures except, as stated in Section 146 (4), where a state court proceeding is pending and the interests of creditors and stockholders would be best subserved in such prior proceedings. The mere pendency of prior state court proceedings is not enough. The

prior state court proceedings herein and the procedure under the Schackno Mortgage Commission Acts are patently not of such character as would warrant the refusal to entertain jurisdiction by the District Court. Certainly there is no ground for holding that the interests of creditors and stockholders would be best served by the dismissal of the Chapter X proceeding.

3. The debtor, who was summarily rebuffed by the trustees, who refused to present its revised plan to the state court should not be disqualified from reorganization in the Federal court. In his dissenting opinion, Judge Clark aptly characterized the attitude of the trustees as follows:

> "* * * the trustees are now acting as dogs in the manger; for they will not present the debtor's revised plan to the state court, and that appears to be the only way it can get there" (R. 101).

Nevertheless, the majority of the Circuit Court below would deprive the debtor of access to the Bankruptcy Court for the purpose of reorganizing, merely because the debtor had previously invoked state court procedures. From the point of view of the majority of the Circuit Court, the debtor is by that token permanently relegated to the state court, even though in actuality he has no standing in the state court. This disqualification would attach to every debtor regardless of any change in circumstances and irrespective of whether the state procedure, which deprives the debtor of all remedy, would best subserve the interests of the creditors and stockholders of the debtor. Apparently the only test employed by the Circuit Court in the present case as well as in the *Marine Harbor* case is whether the debtor ever voluntarily submitted or had been subject to the jurisdiction of the state court. If so, such debtor has no access to the federal

court and the remedies available under Chapter X. That is the view of the majority of the Circuit Court furthermore, notwithstanding the absence of any showing that the interests of creditors and stockholders would be best served by the dismissal of the Chapter X proceeding. As Judge Clark pointed out in his dissent:

> "We have no real evidence on the point save for the affidavits of the appearing parties" (R. 101).

The federal court ought readily to assume jurisdiction over the debtor's petition. Only in that manner could the merits of the revised plan or of a substitute plan be aired with a full regard for the best interests of all concerned, including the debtor, creditors and stockholders. If the holding of the Circuit Court were permitted to stand, however, Federal treatment of the entire situation on the debtor's application would be forever barred, since at one time or another every debtor to mortgage guarantee companies has apparently submitted to the jurisdiction of the state court and would be subject to personal disqualification.

Conclusion.

In the instant case as in *Marine Harbor,* wherein this Court granted the debtor's petition for certiorari, the Circuit Court of Appeals for the Second Circuit invoked the debtor's alleged personal disqualification as the ground for withholding Federal jurisdiction over a debtor's petition under Chapter X, although Section 146 (4) provides an objective standard of good faith as a condition precedent to a debtor's resort to the Federal Courts, to wit, that there be no "prior proceeding pending where it appears that the interest of creditors and stockholders would be best subserved." The majority

of the Circuit Court dispensed with the necessity for an investigation preliminary to making such determination. No such investigation was ever conducted and the debtor was presumed to have been personally disqualified from the mere fact that it had participated in prior state court proceedings. As a result of the failure to weigh the adequacy of the state machinery in the light of Section 146 (4), the protective devices of Chapter X are withheld from creditors and stockholders whose fate is to be determined by demonstrably inadequate state procedures provided in an experimental emergency measure. Moreover, the debtor who is without safeguards under the state procedures has been presumed personally disqualified to invoke the Federal machinery as a result of erroneous construction of the applicable provisions of the statute.

The questions here raised are of significant import in the real estate mortgage situation that has obtained in this country since 1929. It is a Federal question that should be but has not been decided by this Court.

Your petitioner accordingly respectfully prays that this petition for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit be granted.

Dated: May 11th, 1942.

ERWIN FELDMAN,
Attorney for Petitioner,
Paloma Estates, Inc.

State of New York,
County of New York—ss.:

ERWIN FELDMAN, being duly sworn, deposes and says: That he is the attorney for the petitioner named in the foregoing petition. That he has prepared the same and that the allegations thereof are true as he thoroughly believes.

ERWIN FELDMAN.

Subscribed and sworn to before me
this 11th day of May, 1942.

SYDELLE HERMALLIN,
Notary Public,
Bronx County.
Certificate filed in New York County.
Commission expires March 30, 1944.